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No. 94-741

In the Supreme Court of the United States

OCTOBER TERM, 1994

R.A. HILDEBRAND AND
DOROTHY HILDEBRAND WAHL,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the Technology Oil and Gas Associates-1980 partnership did not engage in oil and gas exploitation activities with the actual and honest objective of deriving a profit (as opposed to generating tax writeoffs) and whether the losses reported by this partnership and claimed by petitioners and the other partners as deductions on their individual returns were therefore properly disallowed.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 154-173) is reported at 28 F.3d 1024. The opinion of the United States Tax Court (Pet. App. 1-153) is reported at 99 T.C. 132.

JURISDICTION

The judgment of the court of appeals was entered on June 22, 1994. On September 16, 1994, Justice Ginsburg extended the time in which to file the petition for a writ of certiorari to and including October 20, 1994. The

petition was filed on October 19, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner R.A. Hildebrand was a limited partner in Technology Oil and Gas Associates 1980. Petitioner and his wife deducted losses arising from the partnership investment on their joint federal income tax returns for 1980 through 1982. When the Commissioner of Internal Revenue disallowed those losses, the Hildebrands petitioned the Tax Court for redetermination of the resulting tax deficiencies.

The Tax Court treated the case as a test case for the Elektra/Hemisphere Shelter group, consolidating it with that of Gary E. Krause, Tax Matters Partner of Barton Enhanced Oil Production Income Fund for trial and opinion.* Following a 15-week trial, the Tax Court issued its opinion upholding substantially all of the Commissioner's determinations. Under Section 183(a) of the Internal Revenue Code, 26 U.S.C. 183(a), the Tax Court disallowed the losses claimed by the partnerships because they did not have the requisite profit motive in engaging in their activities (Pet. App. 131). The court also disallowed claimed interest deductions under Section 163 of the Code because the underlying debt obligations of the partnerships were not genuine (Pet. App. 130-131). Finally, under Sections 6661 and 6621(c) of the Code, the Tax Court upheld the Commissioner's application of the increased interest rate applicable to tax underpayments attributable to tax-motivated transactions (Pet. App. 143-144).

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* Krause has also filed a petition for a writ of certiorari (No. 94-729) in this case, to which we have filed a brief in opposition.

The Tax Court's rulings were based on its findings that: (i) the amounts that the partnerships agreed to pay for licenses for enhanced oil recovery (EOR) technology and for a lease of tar sands properties from which oil was to be extracted "bore no relation to the value of that which was acquired, did not conform to industry norms, and precluded any realistic opportunity for profit" (Pet. App. 109-110); (ii) the partnerships' estimates of oil to be recovered through EOR technology were "not supported by credible expert testimony * * * and were not reasonable" in light of the undeveloped and untested status of the EOR technology (*id.* at 110); (iii) the economic projections in the offering materials used by the partnerships reflected a series of unsubstantiated assumptions that did not account for the abnormal cost of the license fees and royalties or the significant cost of establishing commercial operations (*id.* at 111-112); (iv) all but two of the EOR technologies licensed by the partnerships were "undeveloped, untested processes for which no prudent investor would pay any substantial fixed fees," and the other two technologies could have been licensed based solely on the income realized therefrom (*id.* at 117); (v) the partnerships relied on unrealistic projections that "world oil prices would continue increasing from 1979 and 1980 prices on a continuing upward spiral for the next 20 years" (*id.* at 125); (vi) the licensing agreements for the EOR technologies were not the product of arm's-length negotiations (*id.* at 130); and (vii) the partnerships were heavily promoted and marketed on the basis of projected tax benefits and inaccurate information regarding the EOR technology (*id.* at 108-109, 111-112).

2. The court of appeals affirmed (Pet. App. 154-173). The court of appeals concluded that the Tax Court correctly held under Section 183(a) that losses from the

partnerships' transactions are not deductible unless those activities were engaged in with the actual and honest objective of making a profit (Pet. App. 163). The court noted that whether the partnerships had an actual and honest profit objective is a question of fact to be reviewed only for clear error (*id.* at 161). The court of appeals concluded that "[t]he Tax Court did a thorough job of considering the profit motive issue. It applied the relevant factors, considered all the evidence and testimony presented and rested its determination on a solid foundation." *Id.* at 169-170. The court of appeals similarly concluded that the Tax Court's findings that the partnerships' debt obligations were not genuine and that the transactions were tax-motivated were not clearly erroneous (*id.* at 170-171).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Under the general provisions of Section 183(a) of the Internal Revenue Code, if an "activity is not engaged in for profit, no deduction attributable to such activity shall be allowed" (26 U.S.C. 183(a)). In a lengthy opinion that followed a 15-week trial, the Tax Court found, as a fact, that petitioner's partnership did not engage in oil and gas exploitation activities with an actual and honest objective of making a profit but, instead, that the venture was organized and operated to generate tax losses for the partners far in excess of the amounts of their actual investments in the partnership (Pet. App. 131). The court therefore disallowed the loss deductions reported by the partnership and passed on to petitioner and the other partners. The court of appeals, applying the

clearly erroneous standard of review, affirmed the Tax Court's finding that the partnerships' activities lacked a genuine profit motive (*id.* at 169).

Petitioner asserts (Pet. 11-12) that the court of appeals should have reviewed the Tax Court's decision *de novo*. That contention is incorrect, however, because this case involved the fundamentally factual question whether petitioner's partnership had a genuine profit motive or was, instead, nothing more than a tax shelter. The Tax Court's finding that the partnership lacked a bona fide profit motive was quintessentially a finding of fact. It was therefore properly reviewed by the court of appeals under the clearly erroneous standard. The circuit courts have consistently held that a trial court's determination of the existence or non-existence of a profit motive is a factual question to be reviewed only for clear error. See *Wolf* v. *Commissioner*, 4 F.3d 709, 712 (9th Cir. 1993); *Cannon* v. *Commissioner*, 949 F.2d 345, 349 (10th Cir. 1991), cert. denied, 112 S. Ct. 3030 (1992); *Evans* v. *Commissioner*, 908 F.2d 369, 372 (8th Cir. 1990); *Hayden* v. *Commissioner*, 889 F.2d 1548, 1552 (6th Cir. 1989); *Simon* v. *Commissioner*, 830 F.2d 499, 501, 507 (3d Cir. 1987); *Thomas* v. *Commissioner*, 792 F.2d 1256, 1259 (4th Cir. 1986); *Tallal* v. *Commissioner*, 778 F.2d 275, 276 (5th Cir. 1985); *Nickerson* v. *Commissioner*, 700 F.2d 402, 405 (7th Cir. 1983); *Schley* v. *Commissioner*, 375 F.2d 747, 749 (2d Cir. 1967); see also Treas. Reg. § 1.183-2(b) (26 C.F.R.) ("[i]n determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account"). This application of the clearly erroneous standard of review reflects the established principle that determinations of intent or motivation are peculiarly within the province of the trial court. See, *e.g.*, *Commissioner* v. *Duberstein*, 363 U.S. 278, 289 (1960).

2. Petitioners do not contend that the courts below erred by requiring proof of a primary and dominant motive to make a profit under Section 183(a). Instead, petitioners assert (Pet. 37-43) that the courts erred by imposing an additional requirement that the partnerships manifest a "reasonable" expectation of profit, measured by objective standards.

Petitioners can point to no language in the opinions below to establish that they were required to prove that a "reasonable expectation of profit" existed. In fact, the courts did not apply such a standard. The Tax Court found (Pet. App. 130-131) that the partnerships knowingly entered into agreements to pay exorbitant licensing fees—agreements funded mainly by the issuance of bogus promissory notes—for the purpose of generating large tax losses for the limited partners. The court concluded that those losses were not the result of a speculative venture turning out badly but were preordained components of "an attempt to generate significant tax deductions for investors" (*id.* at 131). The court therefore found (*ibid.*) that petitioners failed to prove that the partnership had an actual and honest profit objective.

The court of appeals concluded (Pet. App. 169-170) that the Tax Court "applied the relevant factors, considered all the evidence and testimony presented and rested its determination on a solid foundation." The court of appeals neither expressly nor implicitly adopted or applied a requirement that the partnerships must establish an objectively reasonable expectation of profit. Instead, the court concluded that the partnerships were not entitled to deduct their losses under Section 183(a) because the partnerships "were not *motivated* by profit" (Pet. App. 165, emphasis added).

3. Petitioners contend that the courts below committed "a glaring error of law" (Pet. 44) by discounting evidence of the sale of an interest in a joint venture of the Manhattan partnerships, a group of partnerships that included Technology Oil and Gas Associates 1980. Petitioners maintain that this sale represented an arm's-length transaction with an unrelated party and therefore provides persuasive evidence of the bona fide profit motive of the joint venture.

The transaction on which petitioners rely is the agreement by Pogo Producing Co., a publicly traded corporation, to pay approximately $1.73 million for a 5 percent undivided interest in the profits from certain property that was included in the joint venture (Pet. App. 50, 127-128). The Tax Court declined to give "any credence" to this transaction (*id.* at 127-128) because no representative of Pogo testified at trial and not enough was known about the transaction to ascertain its validity and relevance. Petitioners offered no explanation of why no representative of Pogo testified at trial.

The fact that money was paid and a contract signed does not prove that the transaction was bona fide, at arm's length, and indicative of fair market value. The record in fact contains evidence to the contrary, for there was testimony indicating that Pogo received benefits and guarantees that immunized it from loss from the venture (Tr. 402, 6015-6018). The Tax Court was therefore entirely justified in refusing to give "any credence" to the transaction (Pet. App. 128).

4. Petitioners further contend (Pet. 48-53) that, even if the partnership lacked an actual and honest profit objective, the courts below erred in not allowing interest deductions because the debts that gave rise to the deductions were recourse obligations. Petitioners rely

on *Smith* v. *Commissioner*, 937 F.2d 1089 (6th Cir. 1991), *James* v. *Commissioner*, 899 F.2d 905 (10th Cir. 1990), and *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985), for this proposition. In those cases, deductions were allowed for interest paid on recourse debt even though the debt obligations were issued in connection with a transaction that lacked economic substance. See *Smith* v. *Commissioner*, 937 F.2d at 1098-1099; *James* v. *Commissioner*, 899 F.2d at 910; *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d at 96. Those deductions were permitted when the recourse obligations were "genuine obligations" and the interest paid reflected "an obligation of economic substance" (*ibid.*). In the present case, by contrast, the Tax Court found that the purported debt obligations were not genuine and lacked economic substance (Pet. App. 131). That finding, which was affirmed on appeal (*id.* at 170), does not warrant further review. See *United States* v. *Johnston*, 268 U.S. 220, 227 (1925) ("We do not grant a certiorari to review evidence and discuss specific facts.").

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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